

Fixed Income Absolute Return Amid Sovereign Debt Uncertainty

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Executive Summary

Against the backdrop of a low interest rate environment in much of the developed world, heightened market volatility, and sovereign debt concerns, Paul Brain, Newton's investment leader for fixed income, and Colm McDonagh, head of emerging market fixed income at Insight, discuss the potential benefits of fixed income absolute return approaches.

Why have investors started using fixed income strategies to seek absolute returns?

Paul Brain: One of the main reasons is the threat of higher interest rates and monetary policy tightening by the major central banks, a concern that is likely to continue as economies recover. The other reason is the deteriorating credit quality of some of the government bond markets, and the resulting desire for diversification away from pure bond indices that are based on market capitalization.

Colm McDonagh: In a very low interest rate environment investors are faced with a hurdle regarding the kind of return target they are aiming for. It's not as simple as making an allocation to fixed income, holding it through some volatility and taking the yield through to maturity. Over the past five or six years, we've seen far more volatility in some of the sovereign markets and interest rate markets, so the concept of absolute returns is probably a lot more viable now.

Does a risk-free rate of return exist anymore?

Colm McDonagh: I would say no. We are all used to the theory of a risk-free rate, against which almost everything else is priced. However, the massive shift of liabilities from the private to the public sector has created a lot of issues. While none of the major economies are yet in any real distress, the mere fact that the U.S. has been put on a negative outlook is a stark warning signal. Coming from an emerging markets background with its additional uncertainties, I'm convinced there's no such thing as a risk-free rate.

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¹ See disclosure on page 6.

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Paul Brain: There's no real concept of a risk-free rate; everything has a risk to it, and I think the risks have definitely increased in the U.S. Treasury market now. The risk of policy error from either the Fed or from the government itself has definitely risen. I think when we look at the U.S. Treasury market, we see it as having more risk attached to it.

How does the current market environment compare with the turbulence of 2008?

Colm McDonagh: In 2008, there was a massive bank funding issue, while we are now faced with a public sector funding issue. What lessons can be learned from 2008? You could make the argument that while we have had easy global monetary conditions for a period, and growth remains supportive, the current situation is less acute. However, imagine if growth wasn't supportive. It would not necessarily create a scenario with a Lehman Brothers-type shock, but it could result in a loss of investor confidence in those areas that have traditionally held that confidence.

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Paul Brain: The year 2008 saw the deleveraging or pricking of the credit bubble, which had all sorts of implications for liquidity and credit markets. Now we are seeing the debt being shifted from the private to public sector. This is a shift that can only be temporary, because rating agencies will likely start to highlight the significant increase in debt and how it has to be addressed.

In my view, governments need to focus on fiscal austerity, and we're seeing that quite aggressively across many developed economies. There are two scenarios for fiscal austerity: one is to actually reduce the deficit, growth remains positive, and an improvement in credit outlook is achieved over time. The other one is a failure to achieve sufficient growth, a failure to move to a primary surplus, and the economy falls over and the government ends up defaulting. So the follow-up to a financial crisis can involve either significant inflation or, in some cases, significant defaults as well, so fixed income investors are faced by an uncertain period ahead.

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What would be the likelihood of governments allowing sovereign defaults?

Colm McDonagh: I think exceptionally high in some cases where the levels of debt are simply unsustainable, especially in some Eurozone countries. I believe that will eventually lead to policy action in the form of re-profiling or the extension of maturities. This is effectively default, but it will be managed in such a way that it minimizes the impact on the European banking system. Greece is one of those worst affected, and I doubt that it has the capacity to alter the trajectory of its debt burden in the way that the European Union and European Central Bank hope that it would. As such, a default or similar scenario seems inevitable to me.

Paul Brain: I agree with Colm, and I think the best we can expect is some form of re-profiling or restructuring that doesn't crucify the European banking system. A lot of the Greek debt is now increasingly held by official institutions, and the ECB in particular, so it's perhaps a bit easier to propose a voluntary restructuring rather than an actual default, because most of the holders would likely be in favor of that.

What are the implications of the current investment environment for asset allocation decisions?

Paul Brain: In my view, the run-up to the financial crisis was a becalmed period in which asset allocation was largely forgotten as a tool to diversify risk and potential returns. But as we move into this more turbulent post-financial crisis period, I believe asset allocation will become increasingly important.

How do investors tackle the inherent risk in falling bond indices?

Paul Brain: I believe investors need to acknowledge and manage those risks. I think the problem we have with bond indices is that they are counterintuitive, because they're weighted by market capitalization. The more a country or a company borrows, the greater its weight in that index. Japan is one of the best examples of that. Its share of the global bond index has grown rapidly over the last 20 years, but it's been the worst performing government bond market over that period as well. So if you were an index tracker, you were forced into locking yourself into an underperforming part of the market, just because its weight is going up in the index.

So given the way the indices work, those risks must be recognized. If the index is based on market capitalization, the chances are that the size of a government's deficit is growing and you'll lock yourself into an underperforming government bond market. You can do things about it, such as diversifying away from Japan and investing in other markets. Ultimately, in our view, giving your manager flexibility is very important.

Currency is now probably the most liquid instrument to manage market exposures because that liquidity provides a much bigger transmission mechanism to change an exposure from long to short.

How do you address liquidity risk in fixed income?

Colm McDonagh: I think that in any investment strategy, while it may be easy to enter a trade, you have to make sure you can exit the trade, too, so in my view a liquidity filter is essential. Indeed, a number of long/short strategies in 2008 didn't do particularly well because investors had dropped down on the liquidity curve. The ability to exit positions didn't exist. As a result, liquidity risk has certainly become a greater issue over the past few years.

Paul Brain: As we saw during the credit crisis, liquidity can dry up very rapidly in certain parts of the corporate bond market. I think the secret is to design a strategy that is relatively simple, that fully understands the availability or the liquidity in the market and also understands that liquidity can change and must be monitored. So if you are investing in high yield, an asset class which can be very illiquid at times, you have to monitor that changing liquidity environment and adjust your positions accordingly.

Are there instances when you might push against the boundaries of investment guidelines?

Paul Brain: I think it is important to design a strategy that has a limited amount of guidelines. I think the problem with restrictions is that they can work for a certain period of time, and you might feel that they are providing you with better quality, perhaps more of a safe haven. However, as the credit quality of that underlying asset class changes, perhaps you don't have the ability to avoid it, and you could actually be opening yourself up to more risk with inflexible restrictions.

How can you use currency to achieve absolute returns?

Colm McDonagh: Currency is becoming increasingly more relevant to absolute return strategies. If you go back 10 or 15 years, a number of emerging market countries had currency pegs or managed currency regimes. Part of the evolution of the local currency bond index and bond market is the fact that it obviously makes far more sense for countries to borrow in their own currency. As a result, the bulk of our universe now is invested in local currency instruments, and in 5 or 10 years time, we would expect to see a predominantly local currency universe.

So the volatility of currency, if you look at your standard return on a local market fund, adds about two-thirds of the volatility and potentially contributes massively to performance, either positively or negatively. Currency is now probably the most liquid instrument to manage market exposures because that liquidity provides a much bigger transmission mechanism to change an exposure from long to short.

Fixed income absolute return strategies typically have a stated objective of seeking a return of LIBOR plus 2%, because looking at the investable universe, and the historic levels of return from just having a static weighting to it, it has generally been LIBOR plus 2% with a certain amount of volatility implicit in that.

What sort of return might investors seek from an absolute return fixed income approach in this environment?

Paul Brain: That is a difficult question, because it depends on where you are in the interest rate cycle, the credit cycle, the macroeconomic cycle and so on. Fixed income absolute return strategies typically have a stated objective of seeking a return of LIBOR plus 2%, because looking at the investable universe, and the historic levels of return from just having a static weighting to it, it has generally been LIBOR plus 2% with a certain amount of volatility implicit in that. But if LIBOR is 10% then that means 12%, if LIBOR is 0% that makes 2%, so it does change over time.

Colm McDonagh: We are involved in emerging markets, where there is generally a higher range of volatility and opportunity. Strategies will typically seek to achieve LIBOR plus 4% to 6%, but again, that is over a specific cycle. This year, because we're seeing a transmission mechanism of higher rates, it is likely to be more difficult to generate that rate of return.

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